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Supreme Court Upholds Rule 89(5) in VKC Footsteps Case, Limiting ITC Refunds

Summary: The Supreme Court, in the case of Union of India vs. VKC Footsteps India Pvt. Ltd (https://taxguru.in/goods-and-service-tax/sc-upheld-rule-89-5-validity.html), has upheld the constitutional validity of Rule 89(5) of the CGST Rules, 2017. This ruling clarifies that under an inverted duty structure, taxpayers can only claim refunds for unutilized Input Tax Credit (ITC) pertaining to **input goods**, and not for **input services**. The dispute arose because the definition of "Net ITC" in Rule 89(5) explicitly excluded input services, despite Section 54(3) of the CGST Act allowing refunds for "any unutilized input tax credit." The Court reasoned that the distinction between goods and services is constitutionally recognized, and therefore, Parliament has the discretion to legislate differently for them, especially concerning refunds, which are statutory benefits, not fundamental rights. The Supreme Court agreed with the government's stance that the term "inputs" in Section 54(3) specifically refers to goods. While acknowledging that the formula in Rule 89(5) might lead to inequitable outcomes for businesses, the Court stated that such policy shortcomings do not render the rule unconstitutional. Instead, the Court advised the

GST Council to review the formula and consider policy-level corrections, emphasizing that judicial intervention should not overstep legislative and policy-making domains.

Statement of Problem

The VKC Footsteps case raises a significant issue concerning the interpretation of Section 54(3) of the CGST Act, 2017—specifically, whether the exclusion of input services from refund under Rule 89(5) in cases of inverted duty structure is legally and constitutionally valid. This case needs to be discussed as it brings to light the tension between legislative intent and delegated rule-making, the challenges in ensuring consistency with the fundamental principles of GST such as seamless input credit, and the broader implications on taxpayer equity and refund entitlements. It also reflects the complexities of balancing administrative efficiency with economic fairness in tax policy.

Objectives of the Study

- To critically examine the legal framework of Rule 89(5) and Section 54(3) of the CGST Act in the context of refund of ITC under inverted duty structures.
- To analyze the arguments raised by both the petitioner and the government in VKC Footsteps and understand the Supreme Court's reasoning in upholding Rule 89(5).
- To explore the extent to which this decision aligns with the core principles of GST as a destination-based, value-added tax.
- To assess whether the judgment provides clarity or raises further interpretational ambiguities regarding input tax credit.

Research Hypothesis

The Supreme Court's decision in VKC Footsteps upholding Rule 89(5) is constitutionally and legally sound and does not violate the principles underlying GST law.


Research Questions

1. How does Section 54(3) of the CGST Act provide for refund of unutilised ITC, and what is the legal scope of Rule 89(5)?
2. What is the Supreme Court's approach in VKC Footsteps, and does the ruling undermine or uphold the intended spirit of GST law?
3. What are the practical implications of the VKC Footsteps judgment on businesses with inverted duty structures?

Research Methodology

This research adopts a doctrinal and qualitative approach, primarily focusing on the legal analysis of judicial decisions, statutory provisions, and scholarly literature related to the refund of Input Tax Credit (ITC) (https://taxguru.in/goods-and-service-tax/input-tax-credit-itc-gst-comprehensive-guide.html) under the CGST Act, 2017 (http://taxguru.in/goods-and-service-tax/president-assents-central-goods-services-tax-act-2017.html). The researcher critically examines the Supreme Court's judgment in Union of India v. VKC Footsteps India Pvt. Ltd. in light of Section 54(3) and Rule 89(5) of the CGST Rules, 2017. Emphasis is placed on the interpretation of the legal text, the constitutional validity of delegated legislation, and the balance between taxpayer rights and administrative discretion. Relevant High Court judgments, commentaries, and expert opinions have been considered to understand the divergent judicial views preceding the apex court's decision. This case analysis aims to contribute to the academic discourse by offering a critical perspective on the judgment, its reasoning, and its broader implications for the GST framework in India.

Scope and Limitations

This research is limited to the legal and constitutional analysis of the VKC Footsteps judgment with specific reference to the interpretation of Section 54(3) and Rule 89(5) under the CGST regime. It focuses on the implications for refund of input tax credit in cases of inverted duty structure and covers the judicial reasoning of the Supreme Court, as well as its practical and policy impact on GST implementation. It **NEW** briefly touches upon the legislative and economic philosophy behind GST law in India. 

The research is doctrinal and limited to secondary sources, including judgments, commentaries, and articles. It does not include empirical analysis or taxpayer-level data on the quantum of refunds affected. It confines itself to Indian GST law and does not undertake comparative analysis with foreign tax systems. The project focuses primarily on VKC Footsteps and does not extend to other related cases unless directly relevant. Policy developments post-judgment (e.g., any future amendment to Rule 89(5) or Section 54(3)) may not be within the current scope of discussion.

Introduction

Previously, India had a fragmented tax system across states and sectors, but the vision for the new India is to unify the country with a single tax structure, a single market, and one nation, said Late Shri Arun Jaitley, former Finance Minister. Supporting this vision, Prime Minister Narendra Modi described GST as a Good and Simple Tax.

The Goods and Services Tax (GST), introduced in 2017, was built on the idea of enabling a seamless flow of input tax credit. In simple terms, GST allows businesses to offset the taxes they pay on inputs (goods or services used in production) against their output tax liability. This reduces the overall tax burden on businesses, which in turn helps lower inflation and makes Indian goods and services more competitive in the global market.

Before GST, the tax structure in India was multi-layered and complex. The Central Government imposed taxes like Excise Duty, Service Tax, and Customs Duty, while State Governments levied Sales Tax and Value Added Tax (VAT). However, credits for taxes paid to the Centre could not be used to pay taxes owed to the State, and vice versa. This lack of integration led to accumulated, unusable tax credits for businesses and resulted in higher prices for consumers due to the cascading effect of taxes.

The introduction of GST aimed to eliminate this inefficiency by merging various indirect taxes into a single system and ensuring uninterrupted credit flow across the supply chain. This reform was also expected to control inflation, as emphasized by former Revenue Secretary Hasmukh Adhia, who predicted that GST would contribute to a 2% reduction in inflation, according to national media reports.

1. Judicial Scrutiny of Rule 89(5) & Sec. 54(3): Facts, Legal Framework, and SC Observations

Refund under current GST law

Under the current provisions of GST law, **Section 54(3)[1]** allows for a refund of unutilized input tax credit (ITC) in only two scenarios:

- Export of goods or services, and
- Inverted Duty Structure, where the tax rate on inputs is higher than the tax rate on outputs.

An inverted duty structure arises when a business pays more GST on purchases (inputs) than it collects on its final product or service. For example, if a manufacturer pays 18% GST on raw materials but sells the final product at 5%, the excess credit becomes refundable. However, as per the current legal position under Section 54(3), the refund is allowed only on input goods, not on input services.

This restriction was added through an amendment with retrospective effect from 1 July 2017, and it sparked a dispute between taxpayers and the tax authorities, eventually leading to legal challenges in various High Courts.

VKC Footsteps India Pvt. Ltd. was involved in the manufacturing and supply of footwear, which was subject to GST at an effective rate of 5%. To carry out its operations, the Respondent procured various input goods such as synthetic leather and PU polyol, as well as input services like job work and transportation services. These purchases were largely taxed at higher GST rates of 12% and 18%, and the Respondent claimed input tax credit (ITC) on them. Since the tax rate on inputs and services was greater than the GST rate on the final product, this led to an accumulation of unused ITC in their electronic credit ledger. Given that GST laws allow for refunds of unutilized ITC on goods under an inverted duty structure, the Respondent contested the validity of Rule 89(5) of the CGST Rules, arguing that it unfairly excluded refunds on ITC related to input services.

In 2019, the Gujarat High Court in the **VKC Footsteps India Pvt. Ltd.[2]** case ruled in favor of taxpayers, stating that Rule 89(5) (which allows refund only on goods and not services) was inconsistent with Section 54(3) and thus invalid. In contrast, the Madras High Court, in the **Transtonneltroy Afcons[3]** case, upheld the validity of Rule 89(5), stating that the restriction was legally justified.

Due to these conflicting judgments, the issue was taken up by the Supreme Court, which delivered its verdict on 13th September 2021. The Court sided with the Madras High Court's interpretation and upheld the restriction—thereby confirming that refunds under the inverted duty structure apply only to input goods, not services.

Circumstances that gave rise to the dispute

Rule 89(5) of the CGST Rules, 2017 provides the method for calculating refunds in cases of inverted duty structure. It states:

In such cases, the refund of input tax credit (ITC) will be calculated using the following **formula**:

Under the rule's explanation, the term "Net ITC" specifically refers to the input tax credit availed on inputs during the relevant period. It explicitly excludes ITC claimed under sub-rules (4A) or (4B).

As per Section 2(59)[4] of the CGST Act, 2017, the term "input" means any goods (excluding capital goods) used or intended to be used in the course of business

Therefore, by defining "Net ITC" to include only input goods, the rule excludes input services from the refund calculation under the inverted duty structure. This language in the rule effectively restricts refund eligibility to input goods only, leaving out the tax paid on services altogether.

Issues before the Supreme Court

- i. "Whether the term 'input' used in Section 54(3) of the CGST Act includes both goods and services?"
- ii. "Whether the Rule 89(5) of the CGST Rules was ultra vires to the extent it denied refund of unutilised ITC on input services?"

Arguments of the parties

The **Revenue Department and the Union of India** argued the following points:

1. The distinction between goods and services is both valid and constitutionally recognized. Since goods and services are treated separately under the Constitution, it is reasonable and not arbitrary for the refund rules to treat them differently as well.
2. If the legislature had intended to permit a refund of unutilized input tax credit (ITC) on input services or capital goods, it would have done so explicitly. However, such an intention is not reflected in the current provisions of the law.
3. While the term “unutilized input tax credit” broadly includes ITC on both goods and services, the use of the term in Section 54(3) must be interpreted in context. The legislature has deliberately allowed full refund of ITC (on both goods and services) for zero-rated supplies (such as exports). However, for inverted duty structure, it has intentionally limited the refund to input goods only, as a matter of legislative policy.

The **taxpayer** presented the following key arguments:

1. The core aim of the GST framework is to ensure a seamless flow of input tax credit (ITC). Under Section 54(3) of the CGST Act, refunds of unutilized ITC are allowed, which includes credit on both input goods and input services as per the definitions in the Act. By adding an explanation in Rule 89(5) that limits refunds only to taxes paid on input goods, the executive has unjustifiably narrowed the scope of the provision.
2. The assessee emphasized that Section 54(3) uses the phrase “any unutilized input tax credit”, which should naturally include credit on both goods and services. However, the explanation added to Rule 89(5) restricts this meaning, effectively excluding services, and therefore undermines the broader language used in the statute.
3. The intent behind Rule 89(5) is to provide a mechanism for processing refunds under Section 54(3). However, by introducing restrictions on refund eligibility, Rule 89(5) goes beyond the scope of what Section 54(3) permits, making it inconsistent with the parent Act.
4. The taxpayer argued that the main issue lies in the explanation to Rule 89(5), where “Net ITC” is defined to include only input goods. This narrow definition has led to the dispute, and the phrase “on inputs” in the explanation should therefore be struck down as it is inconsistent with the legislative intent.
5. Lastly, it was pointed out that the GST law does not differentiate between goods and services when it comes to availing or using input tax credit. Thus, creating a distinction only at the refund stage under the inverted duty structure is unjustified and likely not what the legislature intended.

Discussion

1. Goods vs. Services in GST: Necessary Classification or Outdated Distinction?

Rule 89(5) outlines the formula used to determine the maximum refund available from unutilized Input Tax Credit (ITC). An amendment made in April 2018, effective prospectively, excluded input services from this calculation. As a result, many taxpayers were adversely affected, being unable to claim refunds for the unutilized ITC on such services.[5]

The core issue revolves around the differentiation between input goods and input services. The petitioner argued that goods and services are distinct not just constitutionally but also within the CGST Act, which provides separate definitions for each. Therefore, equating the two isn't appropriate, especially considering they are subject to different tax rates, benefits, and exemptions. Since a refund is considered a form of tax exemption, the provision should be interpreted strictly and not expansively.

Conversely, the assessee claimed that any differentiation must have a logical connection to the legislative purpose. While classifications may be justified to enhance revenue, that rationale did not apply in this context. Their contention was that while goods and services are treated equally in terms of tax imposition, the unequal treatment in refund eligibility is unjust.[6]

The Supreme Court, however, upheld Parliament's discretion in making such policy choices, asserting that the classification between input goods and input services was constitutionally valid. It stated that unfairness or inequality arises only when equals are treated unequally or vice versa, which wasn't the case here. Goods and services are fundamentally different categories that happen to be combined only for the purpose of ITC utilization, not refund. Given that refunds are not a constitutional or statutory right, the Court ruled that such differentiation is legally permissible in taxation laws.

2. Interpreting the Limits of Section 54(3) of the CGST Act

Section 54(3) of the CGST Act provides for a refund of unutilized Input Tax Credit (ITC) at the end of a tax period. This refund is permitted in two specific scenarios: (i) for zero-rated supplies, and (ii) under an inverted duty structure—which is relevant in this case. An inverted duty structure occurs when the tax rate on input goods exceeds that on output supplies, leading to the accumulation of unused ITC in the taxpayer's credit ledger.


The dispute centers on the application of Rule 89(5), which defines the method to calculate the refundable ITC but excludes input services from the formula for “Net ITC”. The assessee argued that this imbalance goes against the core purpose of GST, which is to ensure seamless credit flow and eliminate the cascading effect of taxes.

However, the Supreme Court disagreed, emphasizing the restrictive nature of Section 54(3). The use of negative language—such as “no refund” and “in cases other than”—makes it clear that the legislature intended this provision to be limited in scope. Expanding it judicially, the Court noted, would amount to overstepping legislative boundaries. Furthermore, it highlighted that taxpayers with unutilized ITC do not form a uniform group, as the accumulation of ITC may vary depending on specific fiscal policies and economic factors.

3. Examining the Constitutional Validity of Rule 89(5)

Rule 89(5) of the CGST Rules, 2017 lays down the formula for calculating the maximum refund of Input Tax Credit (ITC) in cases of an inverted duty structure. As it currently stands, the amended rule includes only “inputs” in determining net ITC, without clearly defining what “inputs” encompass. This lack of clarity has led to widespread confusion, as authorities interpret it differently.

Some argue that since “input services” are not explicitly mentioned, they should be excluded from refund calculations. Others feel that a strict interpretation goes against the spirit of GST as a consumption-based tax. Reading Section 54(3) alone does not suggest that input services should be excluded, which led the assessee to invoke the doctrine of severability and challenge Rule 89(5).[7]

While the rule is backed by Section 164 of the CGST Act, which empowers the Government to make rules to implement the Act, critics argue that this specific use of that power contradicts the intention of Section 54(3), as it creates an unnecessary divide between goods and services. The Court, however, disagreed and held that Rule 89(5) does not violate the section—particularly since Proviso (2) allows the Government to exempt certain supplies of goods and services. 

Another major concern raised was the flawed formula in Rule 89(5), which was acknowledged by all parties. This flaw leads to unequal treatment of taxpayers:

- Those only dealing with goods under an inverted duty structure cannot claim a refund or utilise the unutilised ITC.
- Those dealing with a mix of goods under both normal and inverted rates can utilise ITC from input services for non-inverted supplies.

All parties agreed that the formula creates an imbalance, yet the Court did not find it sufficient reason to invalidate the rule. Instead of altering or striking it down, the Court advised the GST Council to reconsider the formula and make a policy decision—essentially leaving it to the legislature to resolve the issue.

4. Principle of Equivalence and Its Constitutional Relevance

The principle of equivalence—which advocates for equal treatment of goods and services under value-added taxation—has been cited as a foundational economic rationale for GST. This notion finds reference in the **All India Federation of Tax Practitioners v. Union of India case[8]**, where the Supreme Court acknowledged that goods and services should be treated similarly under a value-added tax system. However, it is important to note that this observation was obiter dicta, not the binding ratio decidendi of the case. It merely served as a commentary on the economic rationale of service tax and VAT, rather than a legally enforceable doctrine.

In **Union of India v. Bengal Shracchi Housing Development Ltd.[9]**, Justice Nariman explicitly clarified the limited legal weight of such economic theories. He emphasized that while concepts like neutrality, equivalence, and cascading effect avoidance may reflect sound fiscal logic, they are not constitutional mandates. Therefore, these economic ideals cannot be used to invalidate a legislation unless they are expressly or impliedly embedded in the constitutional or statutory framework.

This position reinforces the Court's deference to legislative and policy-making domains in fiscal matters. Article 279A(6) of the Constitution, which guides the functioning of the GST Council, underscores the need for a harmonised tax structure and national market, but stops short of constitutionalizing principles such as equivalence or neutrality. Paragraphs 59 and 60 of the VKC Footsteps judgment reiterate that while these doctrines may shape the ideal architecture of a modern GST regime, they cannot form the sole basis of constitutional adjudication.

The judiciary, in this context, has drawn a clear boundary: courts may interpret the law, but cannot expand it to align with economic ideals unless the statute codifies them. This view aligns with the broader constitutional scheme, wherein the Parliament legislates, the Executive implements, and the Judiciary interprets. The Court cannot dictate tax policy or mandate uniformity in rates or coverage, as such directions fall outside the scope of judicial review.

Ultimately, while the doctrine of equivalence reflects what GST ought to achieve—namely, seamless and equal treatment of goods and services—it remains an aspirational economic principle. Its relevance is persuasive at best, not binding, and cannot override the text of the statute. The Supreme Court's position in VKC Footsteps thus reaffirms a conservative and restrained approach, one that respects the separation of powers and the limits of judicial intervention in fiscal legislation.

Supreme Court's Observations

After carefully considering the arguments from both sides, the Supreme Court endorsed the decision of the Madras High Court and made the following observations:

Refunds are not a constitutional entitlement, but a statutory benefit. Therefore, it is within the legislature's authority to define the conditions and procedures under which such refunds are to be granted.

The Court **highlighted** that proviso (ii) to Section 54(3) of the CGST Act specifically uses the term "inputs," which—according to the Act's definition—refers solely to input goods and does not include services. As such, Rule 89(5) is consistent with the statute and does not contradict Section 54(3). If the legislature had intended to include both goods and services, it would not have limited the refund to only "inputs."

Since Rule 89(5) was framed under the authority granted by Section 164 of the CGST Act, it is legally valid and within the powers delegated to the rule-making authority.

The Court **clarified** that just because a tax rule appears inequitable or results in unequal outcomes, it does not automatically become unconstitutional. It maintained that input goods and input services are distinct categories, and hence, the claim that they are being unfairly treated as "equals" is not a valid argument.[10]

Lastly, while the Court **upheld** the validity of Rule 89(5), it acknowledged that the formula used for calculating refunds is inequitable. It therefore encouraged the GST Council to review the issue and consider policy-level corrections.

2. TAKE ON VKC FOOTSTEPS

The author acknowledges that while Rule 89(5) may fall short of capturing the ideal principles of GST—particularly its foundational nature as a consumption-based tax—it does not cross the threshold of unconstitutionality or ultra vires. The Supreme Court's reasoning aligns with a realistic, policy-aware judicial approach, prioritising legislative competence and statutory interpretation over theoretical perfection.

a) On Ultra Vires and Legislative Competence

The author accepts the Court's stand that mere injustice or inconvenience is insufficient to invalidate a tax provision. The crux of ultra vires lies in absence of power, not merely unfair outcomes. Since Section 54(3) empowers the Government to restrict refunds, Rule 89(5) cannot be struck down as ultra vires. The Court's recognition that tax legislation cannot be flawless reflects a pragmatic understanding—that policymaking inherently involves trade-offs and that increased tax burden is not in itself a constitutional infirmity.

b) On Interpretation of Section 54(3) and the Proviso

The Court's interpretation—distinguishing between “input” (goods) and “input services”—is seen by the author as legally sound and balanced. While the petitioner viewed the proviso in Section 54(3)(ii) as relevant only to eligibility, the Court extended it to both eligibility and quantum of refund. The author agrees with this reasonable and constitutionally deferential reading, especially in tax matters where judicial restraint is a guiding principle.^[11]

c) On Ideal Doctrines vs Constitutional Validity

The author is clear that economic doctrines or ideal tax structures—such as the seamless flow of credit—are aspirational, not enforceable constitutional mandates. The judgment rightly separates policy shortcomings from constitutional violations. Unless a provision explicitly violates a constitutional requirement, courts are not empowered to invalidate tax laws based on foreign or economic theories. The emphasis on judicial modesty, particularly in matters of economic legislation, is seen as both consistent and necessary for maintaining institutional boundaries among the legislature, executive, and judiciary.

d) On Separation of Powers and Policy Deference

The author reinforces the Court's view that the design of tax laws and refunds falls within the policy-making domain. The judiciary's role is limited to interpretation and cannot extend to policy prescriptions—like modifying refund formulas or deciding the inclusion of services in net ITC. The author supports this separation of powers, recognising that courts cannot dictate how tax laws should be crafted unless they clearly transgress constitutional limits.

3. IMPACT OF THE CASE

The Supreme Court's ruling has undone the significant relief that many businesses had gained following the Gujarat High Court's efforts to address the unequal treatment between inputs, input services, and capital goods. Numerous taxpayers were already facing substantial capital lock-in due to unutilized ITC on input services, which will now continue to strain their operating costs. The ruling is likely to negatively affect numerous taxpayers who are already struggling with the buildup of input tax credit due to the inverted duty structure, particularly in relation to input services.

Although the Supreme Court has advised the GST Council to examine this inconsistency, taxpayers are now left uncertain. There's also a strong chance that refund claims related to earlier periods may be denied if any favorable changes to the law are applied only moving forward. Additionally, some sectors might see an increase in output tax rates as a possible consequence.

Conclusion

The Supreme Court's observations reflect a mature and constitutionally faithful approach. The judgment does not deny the presence of anomalies or inequities in the refund mechanism but maintains that such flaws do not render the rule unconstitutional. Instead of judicial interference, the legislature and GST Council are the appropriate forums for addressing such policy inconsistencies. This outcome is a measured compromise, affirming the legitimacy of delegated legislation, even if it strays from the ideal vision of GST.

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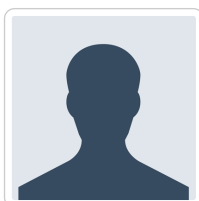


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